1959

Current developments in corporate reorganizations

Laurence O. Eames

Recommended Citation
Haskins & Sells Selected Papers, 1959, p. 312-316

Current Development in Corporate Reorganizations

By Laurence O. Eames
Principal, Washington Office

Presented before the University of Virginia Tax Conference, Charlottesville—June 1959

The Internal Revenue Code of 1954 made very significant changes in the 1939 Code although many of the provisions are not fundamentally different. Actually, the structure of Subchapter C is much easier to work with than the prior rules because the separate parts are arranged and integrated in a more reasonable order.[1]

Some construction problems may be encountered, however, with the provisions of section 368. Note particularly the caption "Definitions Relating to Corporate Reorganizations." The key word is Definitions. A transaction is not nontaxable simply because it meets a definition. For example, a transaction embracing a statutory merger might be the complete liquidation of a subsidiary and thus we would only be concerned with two sections of the Code.[2] Where the transaction does not concern an existing parent and subsidiary corporation or this status can not be imputed, then several provisions of the Code must be consulted before we can establish that the transaction is not taxable.[3] We should look to these other sections and not to the definitions to establish whether a transaction is taxable or nontaxable.

Often it is helpful to disregard the definitions until time to test the conclusion. Stated another way, it is easier to end with, rather than to start with definitions.

RECENT REVENUE RULINGS

Within the last year ten revenue rulings have been published that made reference to the reorganization provisions of the Code. As you might suspect, many of these rulings dealt with the results of a reorganization rather than with the issue of whether or not a plan

[1] For example, see the provisions for Common Nontaxable Exchanges, Part III of Subchapter O. Similar provisions were contained in sections 112 and 113 of the 1939 Code together with the reorganization provisions and other provisions dealing with the basis and recognition of gain or loss.
[2] Sections 332 and 368 (a) (1) (A).
[3] Generally this would relate to sections 354 (a) (1), 361 (a) and 1032 (a).

qualified. Two of these rulings concerned the effect of a reorganization on pension or profit-sharing contributions or benefits.[4]

Two other rulings related to the qualification of the transactions as liquidations in which the corporation would not recognize gain or loss from sale of property within the prescribed 12-month period.[5] One ruling covered the tax return filing requirements after the liquidation of two subsidiaries and the incorporation of the parent corporation in a different state.[6] Of the remaining five rulings, four related to recapitalizations, and one bore upon an attempted distribution in partial liquidation.

The attempted distribution in partial liquidation did not succeed because the distribution was not made "soon after the sale."[7] One of the recapitalizations concerned preferred stock which became "306" stock to some persons but not to others.[8] While at first this may sound strange, if we look at these particular facts we will note that some holders of the old common stock received only new common or only new preferred stock. The stockholders who received both new common and new preferred stock acquired the "306" stigma attaching to their preferred stock. Two of the rulings on recapitalization transactions hold no particular interest for us at this point in

---

[4] Rev. Rul. 58-383, 1958 I.R.B. No. 31, p. 7, held that there was a termination of employment for the employees of the transferor corporation and that the lump-sum distributions to the participants were entitled to the long-term capital gain treatment provided for in section 402 (a) (a) I.R.C. 1954. The reorganization transaction was a stock-for-stock exchange (section 354 (a), defined in section 368 (a) (1) (B), followed by a liquidation of the acquired company (defined as a statutory merger, section 368 (a) (1) (A)). This ruling followed, in point of time, the acquiesence in *Mary Miller*, 22 T.C. 293, Aff'd 226 F. (2d) 618; prior non-acquiesence was withdrawn. The *Judkins* case, 31 T. C. No. 104, cited and followed, among others, the *Miller* case, supra, and Rev. Rul. 58-383, supra.
The second of the pension rulings, Rev. Rul. 58-406, 1958 I.R.B. No. 33, p. 15, concerned a stock for assets transaction (non-taxable under section 361 (a) and defined in section 368 (a) (1) (C)) followed by a consolidation of the qualified pension plans. It was held that this transaction would not result in a disallowance of deductions claimed before the transaction and the transfer did not result in taxable income to the successor corporation.

[5] In Rev. Rul. 58-391, 1958 I.R.B. No. 32, p. 5, there was a determination of the beginning of the 12-month period for an unincorporated club. In Rev. Rul. 59-108, 1959 I.R.B. No. 14, p. 9, the 12-month period started two days before the condemnation, which was held to be a sale, and the resultant award was distributed in liquidation and received after the 12-month period.

[6] See Rev. Rul. 58-422, 1958 I.R.B. No. 34, p. 14. The parent is not required to file separate income tax returns for the periods before and after the merger. The subsidiaries, of course, terminated their taxable year at liquidation. Note that the liquidation of the subsidiaries was nontaxable under section 332 and was defined as a merger under section 368 (a) (1) (A). Also note that the parent was in effect liquidated, nontaxable, and that this constituted a mere change in identity, form, or place of incorporation as defined in section 368 (a) (1) (F) but that the parent's taxable year did not terminate; see Rev. Rul. 57-276, 1957-1 C.B. 126.

[7] See Rev. Rul. 58-565, 1958 I.R.B. 47, p. 9.

[8] Rev. Rul. 59-84, 1959 I.R.B. No. 11, p. 14.

the discussion, as they are concerned more with results than with qualifications.[9]

There was one recent reorganization ruling which does give us some insight with respect to qualifying a reorganization.[10] This ruling considered the word securities as used in the appropriate section of the Internal Revenue Code and concluded that debentures with an average life of 6½ years, when issued to non-stockholders, would constitute a security.

RECENT COURT DECISIONS

When the 1954 Code was enacted, Congress sought to provide relief for taxpayers where corporations sold property at a gain and then liquidated almost immediately.[11] This relief provision was intended to avoid the previous considerations regarding the formalities of the transaction and to look to the end result, so that the tax consequences would not differ because of form.[12] There are, however, several pitfalls in this problem area which deserve our attention. It seems appropriate to first mention the case of *Virginia Ice*.[13] As you probably know, Virginia Ice did not lose its case, but there are some interesting aspects of it that indicate the need for caution. The facts, briefly, are that two pieces of property were sold at a loss immediately before the corporation was completely liquidated. The Court found that the properties were sold before the plan of liquidation was adopted. On the basis of the *Virginia Ice* decision it would seem a taxpayer should sell properties that will produce a loss before a plan of liquidation is adopted and sell properties that will produce a gain after the adoption of the plan.

Another note of caution—this is based on a private ruling issued in January 1959 which may be issued as a Revenue Ruling sometime soon. Assume that the Corporation to be liquidated is domiciled or has property in a state that has an income tax. If the state law does not eliminate the double tax then there will be a state income tax

---

[9] Rev. Rul. 58-397, 1958 I.R.B. No. 32, p. 18, involved a foreign corporation and thus clearance under section 367 was required. Rev. Rul. 58-546, 1958 I.R.B. No. 45, p. 12, concerned a reorganization to reduce debts and resultant reduction of basis of assets within the purview of section 108.

[10] Rev. Rul. 59-98, 1959 I.R.B. 13, p. 12. The exchange of stock for bonds qualified as nontaxable under section 354 (a) (1) and was defined as a recapitalization under section 368 (a) (1) (E).

[11] Section 337. No gain or loss is recognized if a plan is adopted prior to a sale.

[12] Compare *Commissioner* v. *Court Holding Company,* 324 U.S. 331, with U. S. v. Cumberland Public Service Company, 338 U.S. 451

[13] Virginia Ice and Freezing Corp., 30 T.C. No. 132

on gains realized by the corporation. Now you may think this would not be serious but look at the result. No one gets a Federal tax deduction for the state income tax paid. The tax is deemed to be a reduction of the distribution in liquidation.[14] If the state tax is material it would be to the obvious advantage of the stockholders to liquidate first and then sell the assets.

There is another problem connected with section 337 liquidations. There must be a complete liquidation. Of course a reasonable amount of assets may be retained to cover liabilities. However, assume that after liquidation there is discovered the possibility of obtaining a Federal income tax refund arising, say, from a revision of the regulations pertaining to allowable depletion. Presumably the Revenue Service would not recognize a claim for refund filed by the stockholders because the stockholders are not the taxpayer with a right of claim. If the corporation is completely liquidated it can not file a claim and if it is not completely liquidated then the availability of section 337 vanishes.

An actual case may serve to illustrate this point. A cement company adopted a plan of liquidation and obtained an advance ruling under section 337. Sometime after the liquidation the Treasury Department agreed, in principle, that additional statutory depletion was allowable. The cement company filed a claim for refund. The claim was rejected. The reason for rejection was that the tax refund could only be paid to the person (company) who had paid the tax. Thus, if the company was in existence, section 337 did not apply and a substantial capital gains tax was due. If the company was not in existence, there was no capital gains tax to pay but there was no person to file a claim. [Note that this problem might be avoided by filing the claim before liquidation and distributing the right to collect to the stockholders individually or in trust.]

Another interesting recent decision dealt with the problem of divisive reorganizations.[15] The court held that a divisive reorganization under 1954 Code failed because the corporation was not "actively conducting" a trade or business for a sufficient length of time. It was not only the time test that the taxpayer failed to meet in this instance, but also the "active conduct" test, because the latter was

[14] This basis for this conclusion is that a deduction for taxes, section 164 I.R.C., is subject to the general rule of allowance, section 161, which incorporates the exceptions provided in sections 261 through 273. Section 265 states that no deduction shall be allowed for an otherwise allowable deduction allocable to income wholly exempt from income tax.

[15] Elliott, 32 T.C. No. 27

interpreted to mean an activity of substance. Thus, the mere passive receipt of nominal amounts of income [from rent], while easily recognizable as a separate activity, could not be considered as a separate business activity because it was not of consequence.[16]

Possibly there are other decisions which might well be discussed in connection with recent developments in corporate reorganizations, but I believe the most significant development in this general area of taxation is about to occur. I refer to the study of the Special Advisory Group and their recommendations to the Sub-Committee on Internal Revenue Taxation. A summary of the Advisory Group's recommendations has been prepared by the staff of the Joint Committee on Internal Revenue Taxation.

---

[16] See Caplin, *Corporate Division under the 1954 Code: A New Approach to the Five-Year "Active Business" Rule,* 43 Va. L. Rev. 397 (1957), 15 N.Y.U. Tax Inst. 623 (1957).